

Ignore taxation

You are a recently qualified CA(SA) and have been approached by Ms Samira Kahn CA(SA), the Audit Committee Chairperson of HlukileWena Ltd ('HW') about financial reporting matters relating to the company. Samira has provided you with the following information:

Background information

HW was started by a group of young ambitious CAs(SA) and the company specialises in unique clothing items for individuals. The company was incorporated on 1 January 2010 and has grown rapidly since then. It expanded and now has two subsidiaries, namely Leopard Designs (Pty) Ltd ('Leopard') and Boutique Emporium Ltd ('Boutique') as well as an associate, DLH Ltd. It has a 31 December year end and is listed on the Johannesburg Stock Exchange.

The following is an extract from the 'about us' section on the HW website:

HlukileWena is an online service that delivers a truly personalised shopping experience, just for you. Complete your Style Profile and a personal fashion consultant will hand-pick items to fit your tastes, needs and budget – and deliver them directly to your door. Each box contains five items of clothing, shoes and accessories for you to try on at home. Keep what you love and send the rest back in a prepaid DLH package within 30 days. Shipping and returns are free – even for exchanges!

Initially 50% of goods shipped to customers were returned within 30 days, but the personal fashion consultants of HW learned from customer preferences, resulting in a decline in returns to only 15% during the last few years. Control of goods shipped to customers passes on date of delivery.

The company is funded by both equity and debt. Given the current expansion of HW, the debt facilities are crucial for the success of HW. Sanbo Bank extended the debt facilities on the following terms and conditions:

- The debt bears interest at 9% per annum, which is HW's incremental borrowing rate.
- The funding is conditional on a single loan covenant of a debt : equity ratio of no more than 2 : 1. Sanbo Bank has the right to require HW to repay the full amount owing immediately if the covenant is breached.
- Debt is defined as all liabilities recognised in the audited separate statement of financial position.

Samira provided you with the following extracts and additional information from the draft consolidated financial statements of HW:

1 Extracts from HW's draft consolidated financial statements for the year ended 31 December 2018

Extract from the consolidated statement of financial position as at 31 December 2018		
	2018	2017
	R'000	R'000
Assets		
Non-current assets	11 900	9 800
Current assets	134 000	114 000
	145 900	123 800
Equity and liabilities		
Share capital	4 000	4 000
Reserves	42 000	35 000
Equity attributable to owners of the parent	46 000	39 000
Non-controlling interests	3 500	3 000
Total equity	49 500	42 000
Non-current liabilities	9 700	7 600
Current liabilities	86 700	74 200
Liabilities	96 400	81 800
	145 900	123 800

1.1 Accounting policy – revenue recognition

Revenue from contracts with customers is measured based on the consideration that the entity expects to be entitled to in exchange for transferring promised goods to a customer. It excludes amounts collected on behalf of third parties. The group recognises revenue when it transfers risks and rewards relating to a product to a customer, which is deemed to be the date on which the products are dispatched to the customer.

1.2 Interests in group companies

	Country	Share capital	HW effective holding	Non-controlling interest holding
		R'000	%	%
Subsidiaries				
Leopard Designs (Pty) Ltd	South Africa	1 100	100%	–
Boutique Emporium Ltd*	South Africa	800	45%	55%
Associates				
DLH Ltd	South Africa	2 490	21%	n/a

*HW has assessed and concluded that the company controls Boutique Emporium Ltd.

1.3 Related parties

During each period the HW group, in the ordinary course of business, enters into various transactions with related parties at market-related terms.

Associates	Amount of transactions	Amounts due by/(to) related party
Goods and services bought from DLH Ltd	R18 749 000	(R2 014 000)

2 Additional information

2.1 Detailed list of directors and shareholders (not included in the draft consolidated financial statements)

	Shareholders	Percentage held	Directors
HlukileWena Ltd	GrayAllan	11%	C Ramoka T Radebe R Ismail CS van Tonder* M Mathebula*
	Public Investment Corporation	9%	
	YoungMutual	5%	
	Various investors all holding less than 1% each	75%	
Leopard Designs (Pty) Ltd	HlukileWena Ltd	100%	C Ramoka R Ismail M Mathebula*
Boutique Emporium Ltd	HlukileWena Ltd	45%	T Radebe M Mathebula* R Ismail B Suleman*
	Various investors all holding less than 1% each	55%	
DLH Ltd	DLH Europe plc	79%	C Ramoka D Lange A Klose* A Merkcel*
	HlukileWena Ltd	21%	
Retail Investments (Pty) Ltd	HlukileWena Ltd	19%	V Ismail^ J Kotze* L Rokho*

* Non-executive director.

^ V Ismail is the wife of R Ismail.

2.2 Retail Investments (Pty) Ltd

The group has a 19% interest in an unconsolidated structured entity, Retail Investments (Pty) Ltd ('Retail'). Retail is controlled by V Ismail who not only makes all investment decisions but also decides how profits should be distributed.

The maximum exposure of HW is equal to the carrying amount of its investment in Retail. This investment is included in the non-current assets line on the statement of financial position. At 31 December 2018 the carrying amount of the investment in Retail was R2 million.

During the year HW invested an amount of R400 000 with Retail, while a dividend of R600 000 was paid by Retail to HW.

2.3 Designer fabric agreement

During 2016, the Board of Directors of HW decided to embark on a proposal to introduce specialised designer fabric clothing to the online store. The clothing would be made from fabric known as batik, which originates in Ghana. At that stage batik clothing was not available in South Africa and could not be imported.

To secure the supply of batik clothing, HW entered into a five-year supply agreement on 1 January 2017 with Fabric Management Company ('FMC'). FMC is a local subsidiary in accordance with IFRS 10 *Consolidated Financial Statements*, of its Ghanaian parent. FMC specialises in the manufacture of batik fabric and batik clothing and recently completed the setup of the only batik clothing manufacturing plant in South Africa. This is the only group of

companies in the world that has the know-how to produce this very specialised product. The plant is able to produce 100 000 units of batik clothing per annum.

The terms of the five-year supply agreement include the following:

- 1 HW will take up at least 90% of the production for each of the years of the supply agreement and has first right to take up the remaining capacity.
- 2 FMC is not permitted to manufacture batik clothing for parties other than HW without the express permission of HW.
- 3 FMC must take all reasonable steps to ensure it produces at the required capacity.
- 4 HW will specify on a monthly basis the number of units of batik clothing to be manufactured and delivered.
- 5 HW will pay FMC the following amounts:
 - 5.1 An amount per unit of batik clothing will be based on the variable costs of the batik clothing plant and a reasonable profit margin.
 - 5.2 HW must cover all of the fixed costs of the batik clothing plant, initially estimated at R150 000 per month. HW must pay the fixed costs to FMC each month in advance.
 - 5.3 If FMC manufactures and sells products from the batik clothing plant to other clients, the portion of the fixed costs relating to such work will be refunded to HW at the end of the relevant year. For example, if FMC produces and sells 10% of its production output to third parties, then FMC will be liable to refund HW 10% of the fixed costs.

The Financial Director of HW, Mr Tsepo Radebe CA(SA), classified the agreement as the purchase of inventory. He instructed the accountant to recognise the monthly R150 000 fixed cost amount as a product cost to be capitalised to the cost of batik clothing purchased during that month.

The demand for batik clothing has been extremely high and no items of batik clothing were on hand at 31 December 2017 or 31 December 2018.

Samira is concerned about the current accounting treatment of the designer fabric agreement. She did raise this as a concern in 2017 at the Board meeting at which the agreement was initially discussed. The Board resolved that Tsepo carefully consider the classification of the agreement, in view of the loan covenants of HW, and to obtain expert advice if needed.

When Samira approached Tsepo again in December 2018 about the accounting treatment of the agreement, Tsepo was adamant that the accounting treatment was correct and had been signed off by the auditors. He further stated that similar agreements would be proposed during the next financial year (FY2019) to include new designer fabrics such as kente. The intention is to set up a separate company (a special purpose vehicle (SPV)) for these agreements. It would therefore not impact HW, as the SPV would not be consolidated into the group financial statements. HW would make all relevant decisions relating to the SPV and HW would be the sole shareholder of the SPV. 'This will ensure that my hard work is finally recognised in this organisation and that I will receive the bonus I deserve!' Tsepo added.

Additional information

- The HW Board of Directors has determined a quantitative materiality amount of R8 million for both 2017 and 2018.
- HW early adopted IFRS 16 *Leases* with effect from 1 January 2017.
- Assume that FMC did not manufacture and sell products to other clients during either 2017 or 2018.

INITIAL TEST OF COMPETENCE, JUNE 2019

PROFESSIONAL PAPER 2

PAPER 2 QUESTION 1 REQUIRED		Marks	
		Sub-total	Total
<p>Samira has asked you to draft a report for the Audit Committee of HW on the matters below.</p> <p>In all instances ignore taxation.</p> <p>The following is applicable to parts (a) to (e):</p> <ul style="list-style-type: none"> • Round all amounts to the nearest rand. • Round all ratios to two decimal places. <p><i>Communication skills – layout and structure</i></p>		1	1
(a)	<p>Discuss any concerns that you may have and recommend any improvements regarding the revenue recognition policy that was stated in note 1.1.</p> <p>You are not required to re-produce an accounting policy note.</p>	6	6
(b)	<p>Discuss, with reference to IFRS 12, <i>Disclosure of Interests in Other Entities</i>, any additional disclosures in HW's consolidated financial statements for FY2018 that may be required regarding the group's decision to consolidate Boutique.</p>	5	5
(c)	<p>Discuss whether Retail is a related party to HW and, where relevant, provide the disclosures required in terms of IAS 24 <i>Related Parties</i> in HW's consolidated financial statements for FY2018.</p>	6	6
(d)	<p>With regard to the designer fabric agreement –</p> <ul style="list-style-type: none"> (i) discuss the classification of the designer fabric agreement in terms of IFRSs; (ii) calculate, with supporting reasons, whether a material prior period error exists. In your calculations consider the effect on each relevant line item; and (iii) provide the journal entries to account for the agreement in FY2018, assuming the prior period error has already been corrected. <p><i>Communication skills for part (d)(iii) – presentation</i></p>	8 12 6 1	27
(e)	<p>Discuss, with regard to the designer fabric agreement and the FY2019 SPV proposal, any ethical concerns you may have regarding the conduct of Tsepo and recommend actions that Samira as the Audit Committee Chairperson should take in response to your concerns.</p>	8	8
Total for question 1			53